

The Dream Behind the Eurozone

How the Region's Political Aims Led to a Complicated Morning After

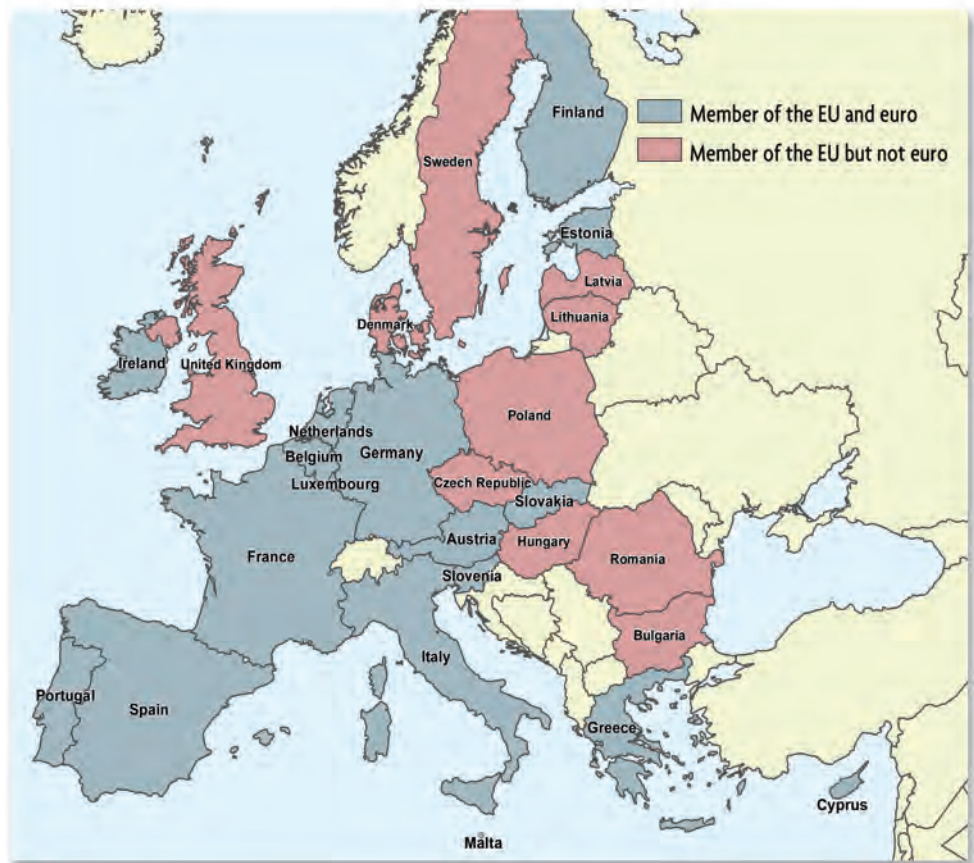
BY RENEE HALTOM

From 27 B.C. to 180 A.D., the territories now covering much of Europe shared some basic governing structures. They had a common legal system that influences Western courts to this day, and even shared a common currency — 2,000 years before the euro came along.

That era of peace, known as *Pax Romana*, replaced two centuries of civil war and conquest. Peace didn't last, of course. After the era ended with the death of emperor Marcus Aurelius, attempts to create a unified Europe came mostly through force, a pattern that persisted right up through World War II. After the war, Winston Churchill called for a revived notion of European political unification to promote lasting peace on the continent.

Hence the idea of a "United States of Europe" is millennia old, and still in progress. Though Europe has achieved far from the degree of political and economic unification of the United States, today it enjoys greater policy coordination and more cross-border trade than ever before in the region's long history.

Still, the viability of Europe's tremendous strides toward economic integration has been called into question during the financial crisis that has afflicted the region since early 2010. Investors have become concerned about the sustainability of current government deficits in light of projections for future spending and anemic economic growth in countries such as Greece, Ireland, Italy, Portugal, and Spain, charging them much higher interest rates for new debt. When the debt of several governments was downgraded, it hurt the financial position of banks that held it, leading to a funding freeze across a continent that was already hampered by the global recession. The problems forced governments to consider dramatic fiscal retrenchments to put their books in order, which have potentially hurt their economies further in the short run and were protested by entire populations.



Europe's economic problems are rooted in long-standing issues. The structural flaws of the European Union, and the euro monetary union in particular, are a byproduct of the political trade-offs required to achieve the last 60 years of economic integration. While many economists remain optimistic about prospects that the euro will pull through its current crisis, most also concede that some of those structural flaws will have to be rectified to ensure the euro's long-term survival.

Steps Toward Integration

The appetite for political reconciliation in Europe was strong following World War II, especially in France and Germany. To make war "not merely unthinkable, but materially impossible," in the words of French Foreign Minister Robert Schuman, Germany and France, along with Belgium, Italy, Luxembourg, and the Netherlands, in 1952 pooled the production of coal and steel through the European Coal and Steel Community (ECSC), the first formal step toward economic integration in Europe.

Politics aside, integration also had plenty of economic justification. Trade allows two regions to specialize and increase production, improving living standards. Expanding the area of trade with additional countries should increase

those gains. Thus, the next step in integration was to create a common market, a free flow of labor, capital, and goods across borders. Along with the ECSC, other economic “communities” were created by 1957’s Treaty of Rome to consolidate the production of major industries. In 1967, the institutions governing the communities were combined into what later became known as the European Community (EC).

European growth slowed with the worldwide oil crunch of the 1970s, leading to a high-unemployment, low-growth era of “Eurosclerosis.” That general economic malaise bled into the 1980s and spurred hundreds of measures to remove all remaining impediments to the flow of labor and other production factors by 1992.

The stronger the EC grew, the greater was the incentive to participate. Denmark, Ireland, and the U.K. joined the six founding members of the ECSC in 1973, followed by Greece, Portugal, and Spain in the early- to mid-1980s. Austria, Finland, and Sweden joined in 1995 — the region had by then received its current name, the European Union (EU) — with eastern European nations joining in the 2000s after the euro was adopted as the region’s common currency. Today there are 27 members of the EU boasting more than half a billion citizens; 17 of those nations belong to the euro monetary union.

The EU’s diverse membership is divided into what are informally known as the “core” and “periphery” of Europe. The core includes the wealthy northern and central nations, such as France, Germany, and Belgium, while the periphery are comprised of the mostly southern poorer countries, such as Greece, Spain, and Portugal. The key question surrounding integration has always been whether membership would cause their incomes to grow closer together or further apart over time. Research by trade economists Paul Krugman and Anthony Venables in 1990 suggested that integration could at first hurt the periphery nations at the benefit of the core as human capital and economic activity flooded to the latter to take advantage of economies of scale. Eventually, however, they predicted some activity would flow back to the periphery to take advantage of cheaper wages.

Empirically, the effects have been uncertain. The incomes of several periphery nations converged after joining, but researchers haven’t agreed on the extent to which that was due to the virtues of economic integration.

(Non)Optimal Currency Areas

The differences between nations mattered most when it came to adopting a common currency. Europe had debated the costs and benefits of taking that step for decades. By eliminating exchange rate risk and the direct costs of changing currency, a common currency promotes trade and investment within the union. The major downside is that regions belonging to a currency union are bound by a single monetary policy, which can at times be too easy for some nations and too tight for others. That’s mostly a problem when nations experience different economic shocks and business cycles.

Still, losing monetary autonomy could be worthwhile if the economies have other means of adjusting to shocks. That rule of thumb was provided by economist Robert Mundell, currently at Columbia University, who in 1961 came up with criteria for when it makes sense for a group of countries to share a currency — that is, whether the countries are an “optimal currency area” (OCA). Each city and town doesn’t need its own currency, but neither should the entire world share one; his goal was to identify the happy medium.

Although the term “optimal currency area” might sound as if the concept is mathematically precise, the criteria that Mundell set out were more like general guidelines: First, nations in a currency union should have high labor mobility between them to provide adjustment to a boom in one and a slump in another. Second, they should have flexible wages and prices to accomplish the same. Third, they generally should experience similar economic shocks. And fourth, there should be a centralized mechanism, such as taxes and transfers from a common fiscal authority, to help regions adjust to localized shocks and weaknesses. A currency union among regions not meeting these criteria would be at risk for rougher business cycles and living standards that grow apart rather than together, leaving some nations worse off on balance. Mundell won the Nobel prize for his work on OCAs and other ideas in 1999, just as the euro was being launched.

Most economists today agree that Europe did not fit Mundell’s criteria for monetary union compatibility. Labor mobility there remains notoriously low, even now. Just 0.1 percent of the EU population moved between member countries annually in the mid-2000s, compared to 2 percent to 2.5 percent of Americans who moved between U.S. states. That’s not for lack of policy support: A Spaniard can get a job in France with his existing passport, no visa required. (The EU migrant must sometimes pass regional licensing exams, just as a lawyer relocating to the Big Apple would have to take the New York bar exam.)

Unfortunately, the remaining barriers to European mobility are difficult to solve through policy. Barriers to moving in the EU are mostly personal, according to a study produced for the European Commission, the executive body of the EU. Language barriers are at the top of the list, which also includes fears about finding relevant job opportunities and cultural differences between old and new locations. That may mean there is a natural limit to European mobility, and therefore also the adjustment to economic shocks.

And Europe’s shocks are much more “asymmetric” than those experienced by the U.S. states, a currency union success case, according to 1997 research by Barry Eichengreen of the University of California, Berkeley and Tamim Bayoumi, currently at the International Monetary Fund. Even when localized shocks occur in the United States, the centralized system of fiscal transfers helps counter them: Social Security, unemployment insurance, subsidies to nonprofits, and the progressive tax system in general.

Jeffrey Sachs and Xavier Sala-i-Martin, both currently at Columbia University, estimated in 1992 that federal taxes and transfers in the United States eliminated as much as 40 percent of declines in regional incomes. Europe has no such mechanism to address regional disturbances.

Some economists argued that it didn't matter that Europe wasn't quite an optimal currency area. It was possible that currency union could work in reverse, actually causing the euro area to become more fit to share a currency by increasing trade and synchronizing business cycles — in other words, that the attributes of an OCA could, to some extent, be generated “endogenously,” as economists put it. The effects of currency union on trade were an obvious area of focus: If commerce between nations picked up, their economies would naturally move more closely together.

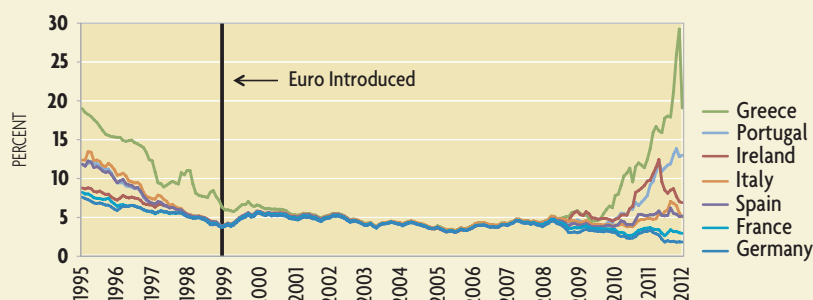
But the theory did not suggest that drastically different economies could be put in alignment by a currency union alone. Even though increased trade resulted from the euro monetary union — somewhere in the vicinity of 20 to 40 percent more since the euro's launch, says economist Andrew Rose of the University of California, Berkeley, who contributed to the endogenous OCA literature — it wasn't enough to make the euro area suddenly qualify as an OCA.

Despite these concerns, a new political impetus for monetary union arose when the Berlin Wall was torn down. “What made the euro feasible was the end of the Cold War and German unification,” says Jacob Kirkegaard at the Peterson Institute for International Economics. When East and West Germany unified in 1990, President François Mitterrand of France wanted to secure a more equal place at the bargaining table with Germany — a goal France had long held, but pushed for even harder given Germany's new economic might. Helmut Kohl, the German “Chancellor of Unity,” as he became known, wanted to overcome that nation's image as a source of instability and three major wars since 1870. He saw monetary union as a way to anchor Germany to Europe. “That's why, in a relatively short period of time, about a year, European leaders negotiated a new and very, very far reaching European treaty,” Kirkegaard says, referring to 1992's Maastricht Treaty to bring Europe's economies closer together in support of a common currency.

The trouble, Rose says, was that the leaders focused on variables that would make the nations look more like an OCA on the surface rather than focusing on the real variables that Mundell emphasized. The Maastricht Treaty established that, to join the euro, countries must converge on nominal indicators — inflation, interest rates, and fiscal measures — that are conceptually different from the real, structural similarities that Mundell said were crucial to ensure nations didn't suffer after having relinquished their monetary and exchange rate policies. “The criteria by which a country gets into the monetary union are simply unrelated to an optimal currency area,” Rose says.

Figure 1: Government Borrowing Rates

Monthly 10-year bond yields



SOURCE: European Commission, data through March 2012

Germany, hesitant to wed itself to less frugal countries, urged adoption of the Stability and Growth Pact (SGP) in 1997 to implement Maastricht's fiscal criteria through the threat of sanctions for breaches. Annual budget deficits were to be kept below 3 percent of GDP, and national debt no larger than 60 percent of GDP, with exceptions allowed when local economies were weak.

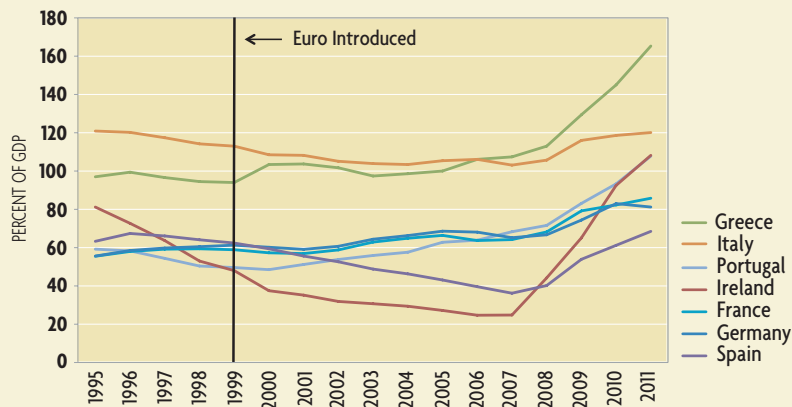
Many economists noted the contradiction between the OCA criteria and Maastricht guidelines, but recognized that the objective of political unity was also a relevant consideration. “The standard of living of the typical European would be lower in the medium term and long term if the [monetary union] goes ahead than if Europe continues with its current economic policies” of integration without monetary union, predicted Martin Feldstein at Harvard, a prominent euro critic, in 1997. “But in the end, it should be for the Europeans themselves to decide whether there are net political advantages of [union] that outweigh the net economic disadvantages.”

From Calm to Crisis

Commerce denominated in euros began on January 1, 1999, and the currency was released in physical form in 2002. For the euro's first 10 years, the economies' fundamental differences didn't seem to matter. The global economy was functioning well. Annual inflation stayed near the target of 2 percent set by the new European Central Bank (ECB), and, even more remarkably, inflation expectations remained anchored despite the ECB's nonexistent performance history. Banks ramped up cross-border lending, and bank regulation became more aligned (although critics argue that Europe still has a long way to go in this regard). Even during the initial stages of the global financial crisis that started in 2008, the euro seemed to anchor periphery nations by preventing speculative attacks and high interest rates.

A byproduct of the euro's initial success was that the interest rates at which governments could borrow converged toward the levels of Germany (see Figure 1), the economic anchor of Europe, despite large fiscal differences between the countries, says Alberto Alesina, an expert at Harvard University on both Europe and fiscal policy. Countries perceived this as a good thing because it allowed those with very high debts, such as Greece and Italy, to sustain them

Figure 2: Government Debt



SOURCE: European Commission, annual data

(see Figure 2). Instead of taking the opportunity provided by low interest rates to get their fiscal houses in order “some countries went on a borrowing binge,” Alesina says. “That was something that economists had not quite expected.”

The fiscal limits in Maastricht and the SGP proved difficult to enforce. Italy, the third largest economy in Europe, and Belgium, the home of the EU capital, were allowed into the monetary union with gross debt almost twice as large as the agreements allowed. Greece falsified official economic data to become the monetary union’s 12th member in 2001, a charge it admitted to in 2004. Within a few years of the euro’s launch, even Germany and France had violated the pact’s deficit limits following the global recession of the early 2000s (see Figure 3). A German official counted in late 2011 that the SGP had been violated 60 times in its 12-year history, with the promised sanctions scantily applied.

Recognizing that the SGP wasn’t serving its intended purpose, it was amended in 2005 to make the fiscal rules more explicit and therefore more enforceable, but the ECB and many economists expressed fears that certain aspects — such as increased reliance on the discretion of the enforcement committee to determine what constituted an acceptable breach of deficit limits — would serve to let governments off the hook. Indeed, Alesina says, “when the financial crisis hit [in 2008], those countries would have been in a better position to deal with it” if they had been living within the treaty’s limits.

When markets began to doubt the viability of sovereign debt in the spring of 2010, Europe had no clear crisis mechanism in place to address these problems. Market volatility reflected that uncertainty, along with growing speculation that Greece and possibly other nations would be forced to leave the euro for being in drastic violation of fiscal rules without agreement to adequate fiscal reform. “Going into the crisis you really only had one institution [the ECB] that was acting on behalf of the entire euro area,” Kirkegaard at the Peterson Institute says. The ECB stepped in as lender of last resort by making large loans to financial institutions to preserve financial market functioning, though it is prohibited under the

Maastricht Treaty from lending directly to governments.

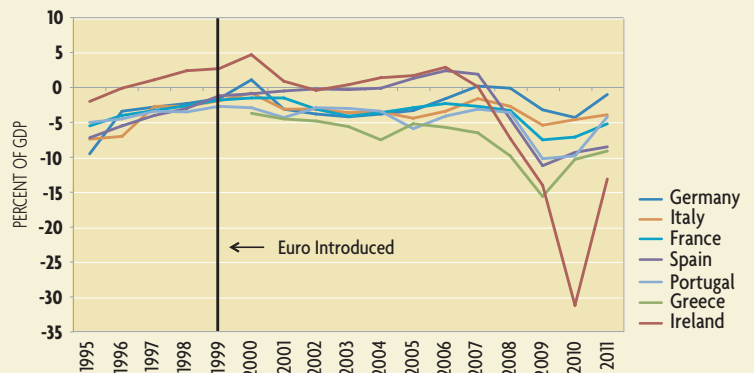
The rest of the crisis response has been marked by one-off interventions and summits to strike deals in hopes of calming markets. The International Monetary Fund and eurozone member states have provided loans to governments in exchange for “austerity” measures to reign in budgets, and EU leaders created two temporary lending facilities guaranteed by member states and the European Commission. In one of the latest deals, holders of Greek government debt agreed in March 2012 to trade their bonds with ones of lower value, reducing the Greek government’s debt — which was by then in excess of 160 percent of GDP — by more than a quarter. It was the largest sovereign debt restructuring in history.

Reassuring markets that governments will avoid default in the short run has been one challenge; reassuring them of governments’ long-run fiscal sustainability has been quite another. In January 2012, most EU states agreed to a “fiscal compact” meant to prevent excessive deficits by writing limits into national constitutions. The compact is “the first step toward fiscal union,” ECB President Mario Draghi told the *Wall Street Journal* in February 2012, a step most European leaders now say is inevitable, but not easy. “Before we move to a fiscal union we have to have in place a system where countries can show that they can stand on their own. And this is the prerequisite for countries to trust each other.”

Previous monetary unions without fiscal union have failed. Examples include the Latin and Scandinavian unions of the 19th century, both of which dissolved after the economic shock of World War I. That’s no coincidence, argued economists Michael Bordo of Rutgers University and Lars Jonung of Lund University in Sweden in several studies comparing currency unions. The available research “tells you loud and clear that monetary unions within nation-states (that are also fiscal unions) do a lot better than international monetary unions,” Bordo said in a recent interview. (See “Interview: Michael Bordo,” *Region Focus*, Fourth Quarter 2011). “My reading of history is that unless they go that way ... they are not going to make it.”

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Figure 3: Government Surplus (+) / Deficit (-)



SOURCE: European Commission, annual data

An Uncertain Path

The degree to which fiscal consolidation will occur depends, like much of the EU's historical development, almost entirely on political will. Countries whose governments would provide stability to a centralized tax and spending system, such as Germany, have little incentive to sign on if indebted nations refuse longer-term fiscal reform within their own borders. The new fiscal compact notwithstanding, that has been difficult to achieve to everybody's satisfaction. Economists and European leaders are far from agreed on which parties should make the greater concessions. Public opinion may be another impediment. Europeans mainly identify with their home countries rather than Europe. "It matters because where you have your self-identity to a large extent indicates in the name of what you're willing to be taxed," Kirkegaard says.

The underlying problem of the eurozone's structure remains: The euro conjoins fundamentally different economies. "Countries like Greece and Portugal have a seri-

ous competitiveness problem," says Rose at UC Berkeley. They are unable to produce as cheaply as the European core, and unable to compensate to boost their growth and exports by devaluing their currencies. That leaves only two options: adjustment through higher unemployment and lower real wages, which several countries are currently experiencing — nearly a quarter of Spaniards are unemployed, the highest rate in the eurozone — or structural reform in labor and product markets to cheapen production, which is not an overnight process. Until structural reform happens, their lack of competitiveness leads to persistent capital outflows, stagnating real wages, and worsening fiscal positions — "exactly what you'd imagine coming out of the optimum currency criteria" when not followed, Rose says.

"That's one of the main reasons that the problems have proven so time consuming to solve for the euro area," Kirkegaard says. "Politically, it's not just about writing a big check and bailing out Greece. It's about correcting some of these design mistakes." **RF**

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